

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ELM OIL COMPANY, LTD. }

Appearances:

For Appellant: Preston D. Orem, Attorney at Law.

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; Harrison Harkins, Assistant Tax Counsel.

O P I N I O N

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protests of Elm Oil Company, Ltd., to his proposed assessments of additional tax in the amounts of \$185.71, \$439.00 and \$820.44, for the taxable years ended December 31, 1935, December 31, 1936, and December 31, 1937, respectively.

During the income years 1934, 1935 and 1936, the Appellant paid to each of its two officers, F. Steiner, its president, and G. Kindeseth, its secretary, as salaries, the respective sums of \$8,000.00, \$12,000.00 and \$15,650.00. The Commissioner has taken the position that these amounts, to the extent that they exceed \$5,000.00 per annum for each of the officers, did not represent "a reasonable allowance for salaries or other compensation for personal services actually rendered..." within the meaning of Section 8(a) of the Act. He has, accordingly, disallowed the balance of the deductions and based his proposed assessments upon that determination.

The Appellant was incorporated on December 31, 1931, during the following two years engaging in the business of oil dehydrating and cleaning, and thereafter operating an oil refinery and selling the products thereof. Although its sales rapidly increased, it apparently did not at any time up to and including the year 1936 operate at a book profit. The amount of its paid capital stock consisted of \$10,000.00, divided equally between Mr. Steiner and Mr. Kindeseth, most of its original invested capital being lost, however, in the course of its early operations. The amounts of its gross sales and the aggregate salaries paid the two officers for each of the years 1932 to 1936, are as follows:

Appeal of Elm Oil Company, Ltd.

<u>Year</u>	<u>Gross Sales</u>	<u>Officers' Salaries</u>
1932	\$ 3,794.90	\$ None
1933	10,172.52	1,440.00
1934	204,565.13	16,000.00
1935	333,783.38	24,000.00
1 9 3 6	452,783.71	31,300.00

It appears from the testimony of Mr. Steiner that the business was built up largely through the personal efforts of himself and Mr. Kindseth, who worked long hours, performing between them all the executive duties required by the enterprise, and that it was understood that if sufficient profits were eventually earned by the company, salaries would be paid which would reflect in part the value of the services rendered during the early years of its existence. It also appears that the cash position of the Appellant has been such that it was never possible to pay the salaries entirely in cash, but that to a large extent the salaries were paid in promissory notes bearing interest at 6 per cent, a substantial portion of which remained outstanding at the time of the company's liquidation in 1938.

On the basis of these facts we believe that the deductions claimed by the Appellant were proper and should have been allowed. It is true, of course, that a corporation will not be permitted to avoid the payment of taxes by distributing profits to its stockholders under the guise of compensating them for services rendered, and that the payment of salaries or bonuses in proportion to the stock ownership of the recipients is sometimes considered as indicating that the payments are in fact distributions of earnings. General Water Heater Co. v. Commissioner, 42 Fed. (2d)419, Am-Plus Storage Battery Co. v. Commissioner, 35 Fed. (2d)167. . Moreover, the steady and marked increase in the amounts paid by the Appellant as compensation to its two officers, which had the effect of absorbing what would otherwise have been a steadily increasing net profit, tends to support the position that the deductions were excessive for the income year 1936, if not for the other years.

On the other hand, however, we believe that in the light of the facts presented by the record it is not unreasonable to assume that the two men contributed equally to the success of the enterprise and, consequently, we do not regard as particularly significant the fact that both their salaries and their stock ownership were identical. In determining whether the salaries paid were excessive, consideration must be given to the responsibilities assumed and the arduous duties performed by the two men, to their success in building up and carrying on the business with a limited amount of capital, and to the almost negligible compensation received by them during the first two years of the company's existence. See Appeal of Webb & Bocorselski, Inc., 1 B. 'I'. A. 871, Skinner Manufacturing Co. v. United States, 8 F. Supp. 741,

Appeal of Elm Oil Company, Ltd.

Taylor-Logan Co. v. White, 65 Fed. (2d)994. In view of these factors we are of the opinion that the salaries paid were not unreasonable and that the entire amounts thereof constituted proper deductions from gross income.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Elm Oil Company, Ltd., to proposed assessments of additional tax in the amounts of \$185.71, \$439.00 and \$820.44 for the taxable years ended December 31, 1935, December 31, 1936, and December 31, 1937, respectively, pursuant to Chapter 13, Statutes of 1929 as amended, be and the same is hereby reversed. Said ruling is hereby set aside and the said Commissioner is hereby directed to proceed in conformity with this order.

Done at Sacramento, California, this 2nd day of December, 1942, by the State Board of Equalization.

R. E. Collins, Chairman
George R. Reilly, Member
Wm. G. Bonelli, Member

ATTEST: Dixwell L. Pierce, Secretary